BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA

DOCKET NO. 2018-318-E

In the Matter of	)	**REBUTTAL TESTIMONY OF**
	)	**JOHN L. SULLIVAN, III**
Application of Duke Energy Progress, LLC for	)	**FOR DUKE ENERGY**
Adjustments in Electronic Rate Schedules And	)	**PROGRESS, LLC**
Tariffs and Request for an Accounting Order	)	

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND CURRENT POSITION.

A. My name is John L. Sullivan, III. My business address is 550 South Tryon Street, Charlotte, North Carolina. I am employed by Duke Energy Business Services, LLC as Director, Corporate Finance and Assistant Treasurer. I am also the Assistant Treasurer of Duke Energy Progress, LLC ("DE Progress" or the "Company").

Q. DID YOU PREVIOUSLY FILE DIRECT TESTIMONY AND EXHIBITS IN THIS PROCEEDING?

A. Yes, I did.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to portions of the testimony filed by Mr. David Parcell, witness on behalf of the South Carolina Office of Regulatory Staff ("ORS").~~, and Ms. Billie LaConte, witness on behalf of Nucor Steel – South Carolina ("Nucor").~~

First, I address Witness Parcell's recommendation for the cost of long-term debt. ~~Second, I address the effects of Witness LaConte's proposal to reduce the amortization period of the unprotected excess deferred income taxes ("EDIT") related to the Company's investments in property, plant, and equipment ("PP&E") assets. Third, I address Witness LaConte's assertion that DE Progress' proposed common equity ratio is too high. Lastly,~~ I will also address Witness Parcell's recommended Return on

Equity ("ROE") and the financial impacts to the Company from the overall revenue requirement recommendation of the ORS.

Q. PLEASE PROVIDE AN OVERVIEW OF YOUR TESTIMONY.

A. First, the ORS proposes to use the 4.06% cost of debt as of December 31, 2017 originally filed in my direct testimony. This adoption is inconsistent with the ORS's proposal to update the cost of debt in Duke Energy Carolinas, LLC's ("DE Carolinas") pending South Carolina rate case to reflect 2018 long-term debt financing activity. I recommend using DE Progress' updated 4.16% cost of debt calculated as of December 31, 2018. The methodology we use in calculating this updated cost of debt is the same we employed when updating the DE Carolinas cost of debt as of December 31, 2018.

~~Second, with respect to the return of PP&E-related unprotected EDIT, Nucor Witness LaConte, advocates for a five-year flowback period in the Company's revenue requirement to benefit customers following the Tax Cuts & Jobs Act (the "Tax Act"). While it is clear that customers should, and ultimately will, benefit from the overall reduction in the revenue requirement, the Commission should also take into account other impacts of the Tax Act, particularly as it relates to cash flow. In March 2018, Moody's Investors Service ("Moody's") in its Credit Opinion of DE Progress identified tax reform as one of several factors that could adversely impact the Company's financial metrics (specifically, cash flow coverage~~

~~ratios).[1] As indicated in my direct testimony, the Company's capital requirements for the next three years (2019-2021) are projected to be approximately $7.6 billion. This amount consists of approximately $6.1 billion in projected capital expenditures and approximately $1.5 billion in debt retirements which must be refinanced with new capital. Reducing the Company's cash flow through a more accelerated flowback of unprotected EDIT at the same time DE Progress is investing in large capital projects and faced with large refinancing obligations will negatively impact its credit metrics, which must be taken into account.~~

~~Third, in contrast to my direct testimony, in which I proposed a capital structure of 53% equity and 47% debt, Witness LaConte requests the Commission to consider reducing the equity ratio to be more in line with other similar Standard & Poor's ("S&P") "A-" rated companies. My rebuttal testimony addresses the flaws I see in her analyses.~~

~~Last,~~ I also examine the detrimental impacts to the Company of Witness Parcell's recommended 9.30% ROE and the overall revenue requirement proposed by the ORS. The ORS's recommendation does not take into account the adverse impacts the reduced cash flows would have on credit quality. These impacts could be severe, to the detriment of the Company's credit quality and the interests of its customers. The Company's regulatory capital structure and allowed ROE are key components in

~~[1] *See* Moody's Investors Service, Credit Opinion, "Duke Energy Progress, LLC – Update to Credit Analysis," March 19, 2018 ("March 2018 DE Progress Report").~~

maintaining the Company's current "A" credit ratings and its overall financial strength and flexibility.

Q. THE ORS ADOPTS THE 4.06% COST OF DEBT AS FILED BY THE COMPANY. IS THIS CONSISTENT WITH THEIR POSITION IN THE DE CAROLINAS RATE CASE?

A. No. In the DE Carolinas rate case, Witness Parcell proposed the cost of debt be reduced from 4.63% (as of December 31, 2017) to 4.44% (as of December 31, 2018) to reflect certain long-term debt issuances in 2018. DE Carolinas agreed to reflect the updated cost of debt as of December 31, 2018 but calculated a year-end rate of 4.53% to reflect Witness Parcell's update for long-term debt issuances as well as all other changes to DE Carolinas long-term debt profile – which is still 10 basis points lower than the Company's original debt rate as of December 31, 2017. For consistency, DE Progress recommends the cost of debt be updated to 4.16% to reflect all long-term debt financing activity through year-end 2018. Please see Sullivan Rebuttal Exhibit 1, which includes my updated cost of debt calculation as of December 31, 2018.

~~**Q. DO YOU AGREE WITH NUCOR'S RECOMMENDATION FOR RETURNING PP&E-RELATED UNPROTECTED EDIT OVER A 5-YEAR PERIOD?**~~

~~**A. NO. WITNESS LACONTE RECOMMENDS PP&E-RELATED UNPROTECTED EDIT OF APPROXIMATELY $58.3 MILLION BE FLOWED BACK TO CUSTOMERS OVER A FIVE-YEAR PERIOD**~~

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~~VERSUS THE COMPANY'S RECOMMENDATION OF A 20-YEAR FLOWBACK PERIOD. WITNESS LACONTE DOES NOT CONSIDER THE LONGER-TERM BENEFITS TO CUSTOMERS OF A LONGER FLOWBACK PERIOD, AS EDIT BALANCES OFFSET RATE BASE AS A REGULATORY LIABILITY ON THE COMPANY'S BALANCE SHEET AT A ZERO-PERCENT COST OF CAPITAL.~~

~~THROUGH ITS PROPOSED EDIT RIDER, THE COMPANY ADVOCATES A 20-YEAR AMORTIZATION OF THE REGULATORY LIABILITY AS STATED IN COMPANY WITNESS JOHN PANIZZA'S DIRECT AND REBUTTAL TESTIMONY. MR. PANIZZA FURTHER DESCRIBES THE RATIONALE FOR THE 20-YEAR AMORTIZATION AS IT MORE CLOSELY MATCHES THE REMAINING LIFE OF THE UNDERLYING PP&E ASSETS, LESSENS THE CASH FLOW IMPACTS TO THE COMPANY, AND REDUCES THE VOLATILITY IN CUSTOMER RATES.~~

~~Q. IS IT REASONABLE THAT CUSTOMERS SHOULD BENEFIT FROM THE CHANGES IN THE COMPANY'S COST TO SERVE AS A RESULT OF THE TAX ACT?~~

~~A. Yes, customers should benefit, and they will. It is also incumbent on the Commission to ensure that customers receive reliable utility service at reasonable rates. Without the Commission's thoughtful consideration regarding all aspects of the Tax Act, the Company could be adversely~~

~~affected by the legislation, particularly through a reduction in cash flow which is vital to the Company's credit quality.~~

~~As this Commission is well aware, electric utilities are one of the most capital intensive industries in the country. The Company invests in infrastructure not because of federal tax policy, but because it is critical, necessary and often legally-required that it do so. Our statutory obligation to serve requires the financial strength to support our commitments to our customers on a reliable and cost-effective basis. Credit quality drives access to affordable capital, and for this reason it is in the best interest of customers to prevent a weakening of the Company's cash flow and credit quality from pre-Tax Act levels.~~

~~The Tax Act represents a unique opportunity to deliver savings to customers, but, as with all ratemaking actions, the interests of customers and the Company must be balanced. Adjusting utility rates solely to account for the impact of the reduction in the federal corporate tax rate and an accelerated flowback of excess deferred taxes without giving consideration to the impact of all other ratemaking considerations is not appropriate.~~

~~Q. COULD DE PROGRESS' FINANCIAL CONDITION BE HARMED AS A RESULT OF A 5-YEAR FLOWBACK OF PP&E RELATED UNPROTECTED EDIT?~~

~~A. Yes. An accelerated return of EDIT over an arbitrary five-year period would adversely impact the Company's cash flow to fund ongoing~~

~~operations and new infrastructure investments. An unmitigated cash flow shortfall could force the Company to rely excessively on third-party capital to fund itself, to the ultimate detriment of its financial condition.~~

~~Conversely, the 20-year flow back of unprotected PP&E-related EDIT is proposed to balance the interests of customers with the financial strength and cash flows of the Company. The Federal tax law changes provide the Commission an opportunity to help reduce and levelize customer rates over the short- and longer-term, while maintaining the utility's ability to provide safe, reliable and affordable rates.~~

~~Q. HAVE OTHER UTILITY COMMISSIONS TAKEN STEPS TO MITIGATE THE NEGATIVE IMPACTS OF TAX REFORM?~~

~~A. Yes, as stated in my direct testimony, examples include:~~

- ~~In North Carolina, the North Carolina Utilities Commission ("NCUC") addressed tax reform in DE Carolinas' most recent rate case. The Commission's order in that case implemented the lower federal tax rate (to 21 percent from 35 percent) but also allowed DE Carolinas to delay the giveback of protected and unprotected excess deferred income taxes until the earlier of 3 years or its next base rate case.[2] In its August 2018 Duke Energy Report, Moody's refers to this delay of EDIT flowback as credit positive and describes how it gives the NCUC time to "evaluate how best to return this value to~~

[2] ~~*Order Accepting Stipulation, Deciding Contested Issues, and Requiring Revenue Reduction*, Docket No. E-7, Sub 1146 (NCUC June 22, 2018).~~

~~customers," which may come in the form of "accelerated recovery of certain expenses, or the avoidance of rate increases."[3]~~

- ~~In Florida, the Florida Public Service Commission ordered Duke Energy Florida to accelerate depreciation of coal assets by $50 million per year. It also granted Duke Energy Florida the ability to utilize the remainder of the customer benefits of a lower tax rate to avoid a rate increase for power restoration costs associated with Hurricane Irma. In August 2018, Moody's stated that it views "these tax reform related developments as supportive of credit quality."[4]~~
- ~~The Indiana Utility Regulatory Commission also issued a credit-supportive order to mitigate the near-term impacts of tax reform. Duke Energy Indiana was authorized a 10-year amortization period of approximately $167 million unprotected excess accumulated deferred income tax. However, the refund to customers is limited to $7 million per year in the first five years, increasing to $35 million per year until the entire deferral amount has been returned to customers. This back-end shaping of the deferral is credit-supportive as it limits the near-term negative impact to the utility from lower cash flows and allows the utility more time to prepare for and absorb the higher payback obligation.~~

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[3] ~~*See* Moody's Investors Service, Credit Opinion, "Duke Energy Corporation – Update to credit analysis," August 14, 2018, p. 4 ("August 2018 Duke Energy Report")~~
[4] ~~August 2018 Duke Energy Report, p. 4~~

- ~~In Georgia, a settlement between Georgia Power and the commission staff puts off EDIT issues for two years, and increases the equity portion of the utility's equity-to-debt ratio while flowing back to customers the effects of the tax rate decrease. Adjustments to the utility's ROE or equity layer are on the Moody's list of credit positive mitigation measures.~~[5]

~~Q. PLEASE SUMMARIZE THE KEY POINTS MADE BY WITNESS LACONTE REGARDING YOUR RECOMMENDATION THAT THE COMPANY'S CAPITAL STRUCTURE BE 53% EQUITY AND 47% DEBT.~~

~~A. Witness LaConte recommends the Commission consider reducing DE Progress' proposed 53% equity ratio on the basis that it is above the industry average. She compares the capital structure of DE Progress, a regulated utility operating company, with the capital structures of similar S&P "A-" rated companies. However, Witness LaConte's group of supposedly "comparable utilities" includes two publicly-traded utility holding companies which are not subject to regulated capital structures, and therefore are not comparable to DE Progress.~~

~~In addition, Witness LaConte's comparison of capital structures against similarly rated companies uses Generally Accepted Accounting Principles ("GAAP") methodology. Regulated utilities make adjustments to their GAAP capital structures for regulatory reporting purposes. Like the~~

~~[5] *See* Moody's Investors Service, Sector Comment, "Tax Reform is Credit Negative for Sector, but Impact Varies by Company," January 24, 2018, p. 4 ("January 2018 Report")~~

~~other equity ratios shown in LaConte Exhibit 7, the 51.13% equity ratio for DE Progress is a GAAP view of the Company's capital structure. However, the Company's regulated capital structure as of December 31, 2017 and December 31, 2018 have consistently remained above 53.0% (Sullivan Rebuttal Exhibits 2 and 3).~~

~~**Q. LACONTE EXHIBIT 7 COMPARES ACTUAL TEST PERIOD CAPITAL STRUCTURES FOR THE CALCULATION OF INDUSTRY AVERAGE EQUITY RATIO. DO YOU AGREE THAT IS THE APPROPRIATE EQUITY RATIO FOR PURPOSES OF EVALUATING DE PROGRESS' REGULATORY CAPITAL STRUCTURE?**~~

~~A. No, I do not. Witness LaConte uses a GAAP methodology to calculate each company's equity ratio. DE Progress files quarterly capital structure reports (Sullivan Rebuttal Exhibits 2 and 3) with the Commission and ORS, which uses the South Carolina rate base method and includes adjustments to the Company's equity and long-term debt that are not included in the GAAP methodology. Simply adjusting the capital structures of the operating utilities' capital structures in LaConte Exhibit 7 to reflect a structure comprising only long-term debt and equity, increases the average equity ratio of the regulated utility comparable companies to above 53.0% (Sullivan Rebuttal Exhibit 4).~~

~~As noted in my direct testimony, the specific debt/equity ratio will vary over time, depending on the timing and size of debt issuances, seasonality of earnings, and dividend payments to the parent company. A regulated capital structure consisting of 53% equity is consistent with the Company's financial objectives and preserves its ability to finance the business at rates favorable for customers. A healthy capital structure and an adequate return on equity provide balance sheet protection and cash flow~~

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~~generation to support high credit quality. High credit quality creates financial flexibility by providing more readily available access to the capital markets on reasonable terms, and ultimately lower debt financing costs.~~

Q. WITNESS PARCELL'S ANALYSES ESTIMATED THE COMPANY'S ROE TO BE IN A RANGE OF 9.10% TO 9.50%, WITH A RECOMMENDED MID-POINT ESTIMATE OF 9.30%. HOW DOES THIS COMPARE WITH COMPANY WITNESS ROBERT HEVERT'S ROE RECOMMENDATION?

A. Mr. Parcell's 9.30% ROE recommendation is 145 basis points below Company Witness Hevert's recommended point estimate of 10.75%. In his direct testimony, and maintained in his rebuttal testimony, Mr. Hevert believes that an ROE in the range of 10.25% to 11.00%, with a point estimate of 10.75% is commensurate with his quantitative and qualitative analyses of DE Progress. As stated in my direct testimony, the Company fully supports Witness Hevert's proposed ROE and analysis, yet offered a 25 basis point concession with rates being set in conjunction with a ROE of 10.50%. Approval of this request will allow the Company to maintain its healthy credit profile, generate adequate cash flow to support its critical capital investments, and fairly balance the needs of affordable electric rates for customers and an acceptable ROE for equity investors.